

Circular Flow

and Economic Growth and Economic Development

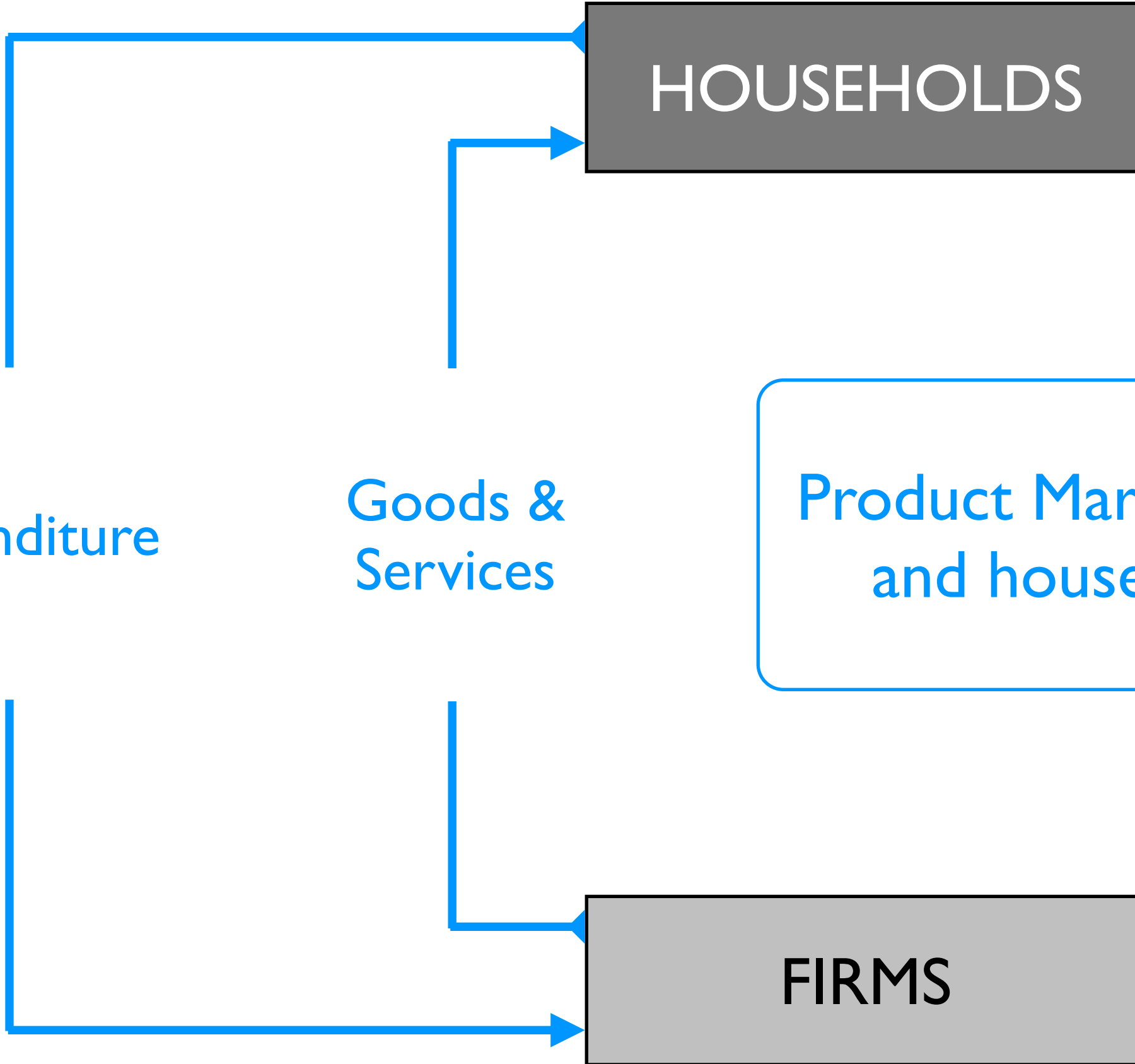
HOUSEHOLDS

Product Market: firms sell
and households buy.

FIRMS

Expenditure

Goods &
Services



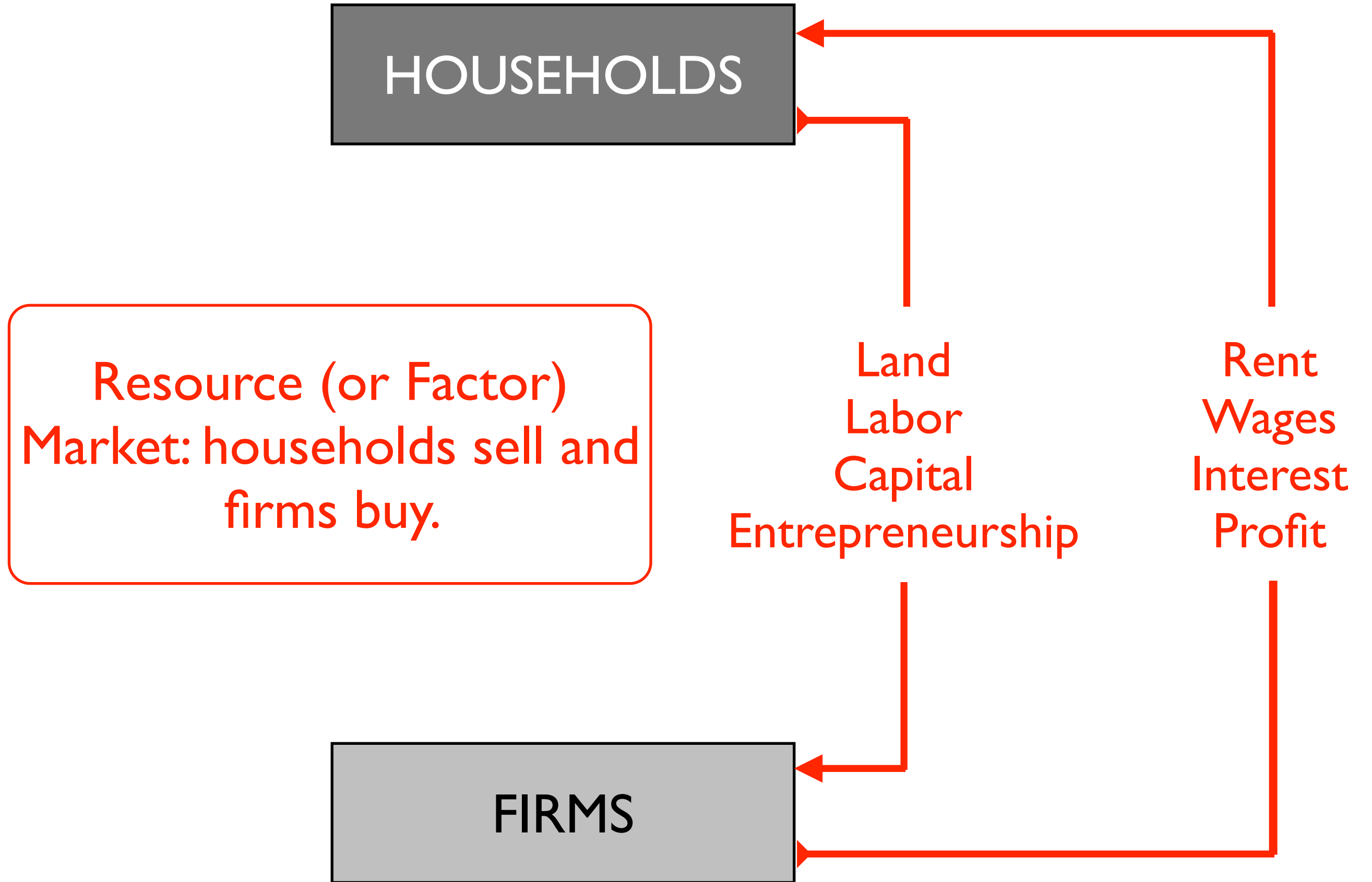
HOUSEHOLDS

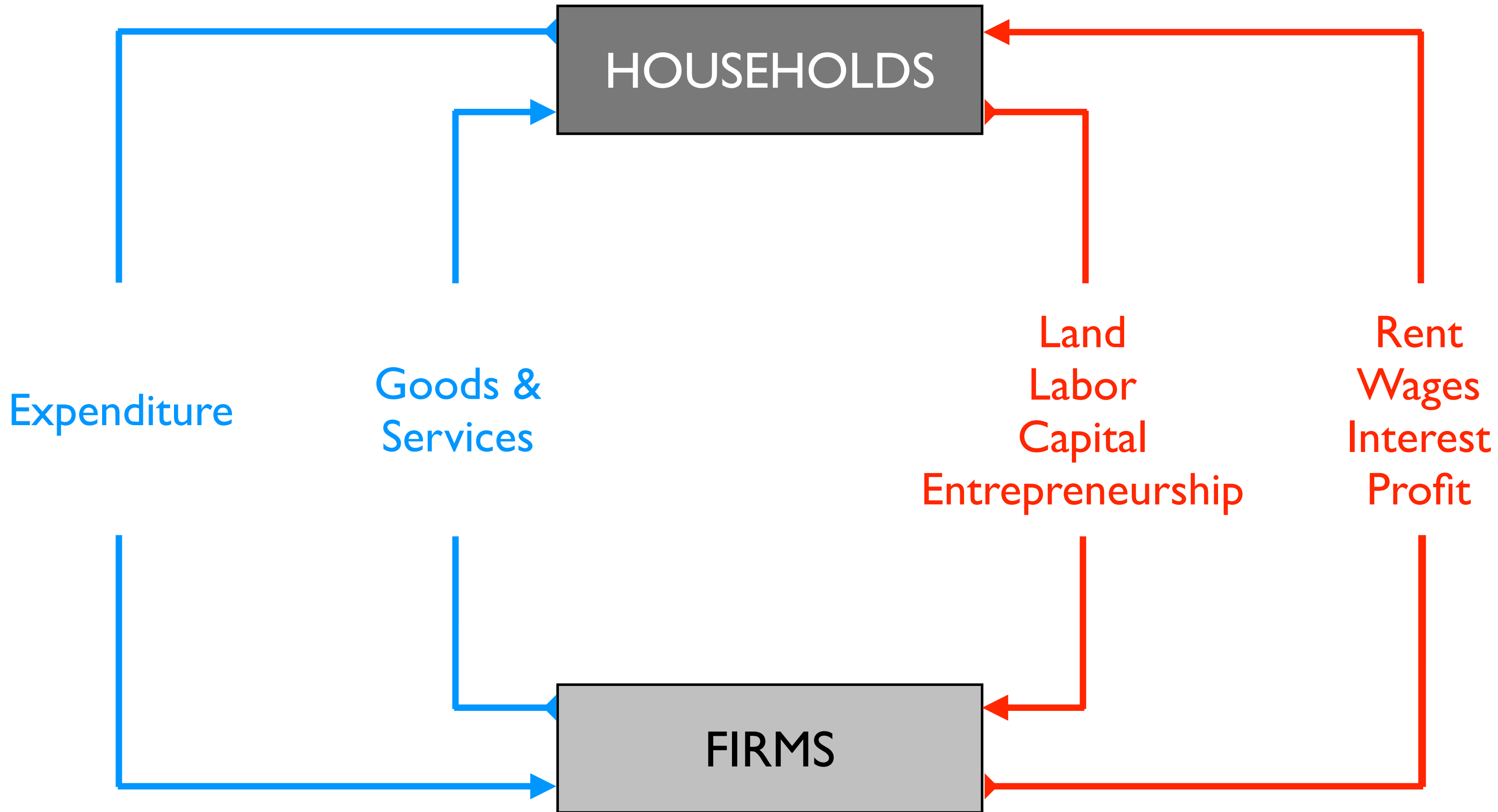
Resource (or Factor)
Market: households sell and
firms buy.

FIRMS

Land
Labor
Capital
Entrepreneurship

Rent
Wages
Interest
Profit





We can measure the “size” of the economy by adding up all the activity along one of three paths. The primary statistic used to measure the size of the economy is **Gross Domestic Product** (or **GDP**).

A diagram illustrating the flow of expenditure. At the top, a grey rectangular box labeled 'HOUSEHOLDS' has a blue line extending from its left side, which then turns downwards and then rightwards to point at a grey rectangular box labeled 'FIRMS' at the bottom. In the center, a blue-bordered rounded rectangle contains the text 'We can add up all the money households spend on goods and services.' To the left of this central box, the word 'Expenditure' is written in blue. The entire diagram is set against a white background.

HOUSEHOLDS

We can add up all the
money households spend
on goods and services.

FIRMS

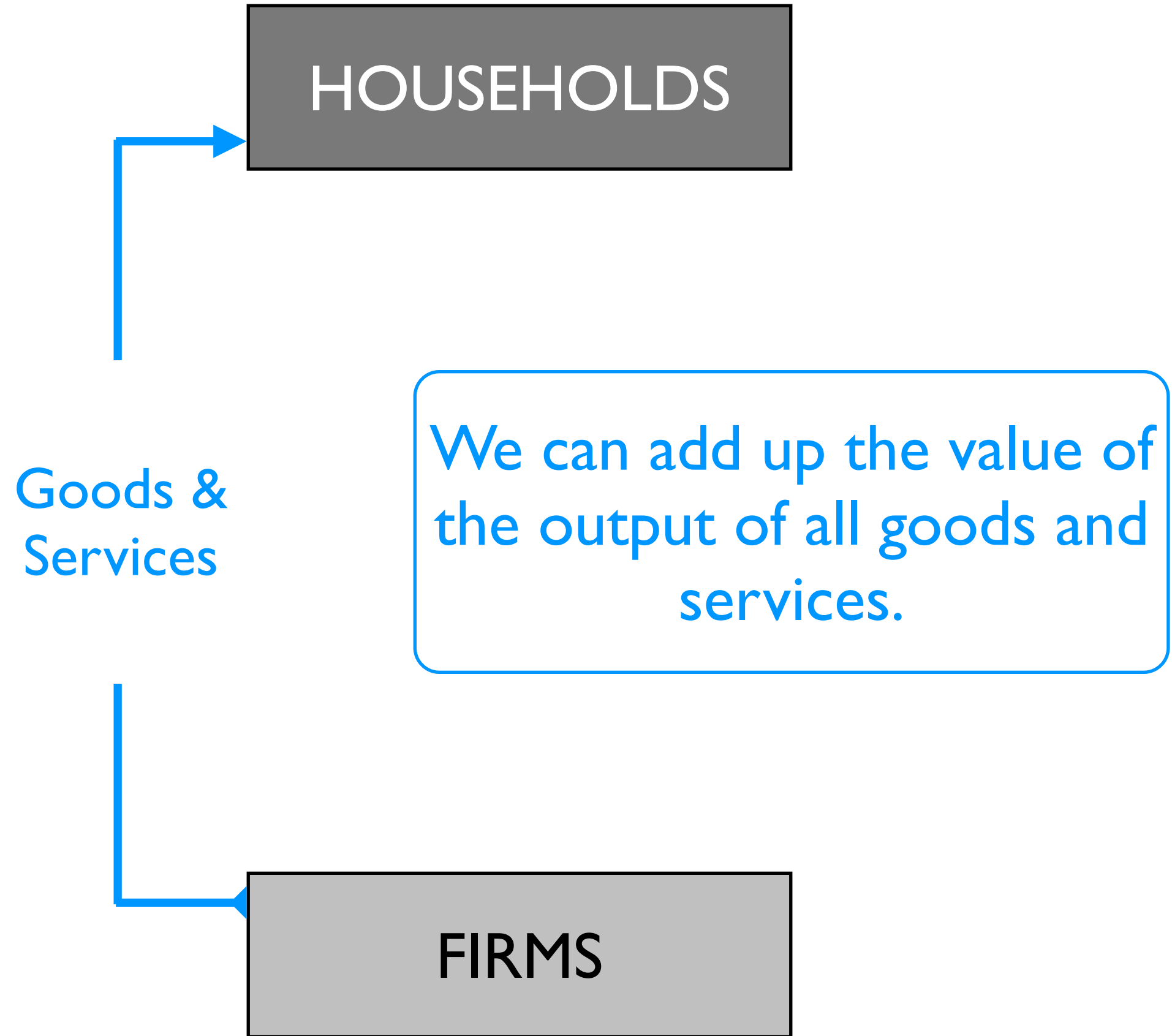
Expenditure

HOUSEHOLDS

Goods &
Services

We can add up the value of
the output of all goods and
services.

FIRMS



HOUSEHOLDS

We can add up the
incomes of households for
letting firms use their
factors of production.

FIRMS

Rent
Wages
Interest
Profit

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graph TD; F[FIRMS] --> H[HOUSEHOLDS];
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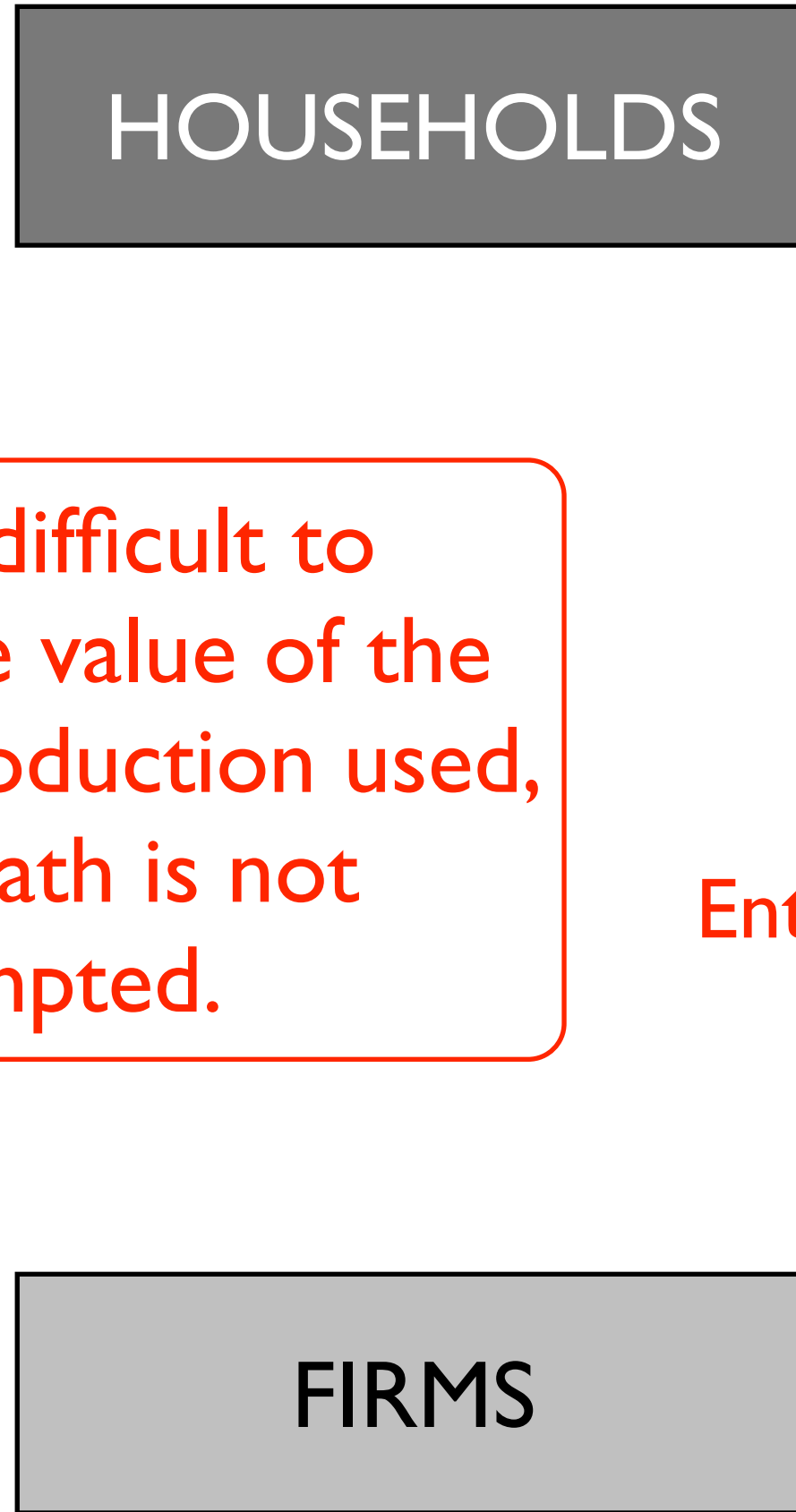
The diagram illustrates the flow of income from firms to households. A red arrow originates from the right side of the 'FIRMS' box and points to the right. It then turns upwards and then leftwards, ending with an arrowhead pointing into the right side of the 'HOUSEHOLDS' box. To the right of this arrow, the following income components are listed vertically: Rent, Wages, Interest, and Profit.

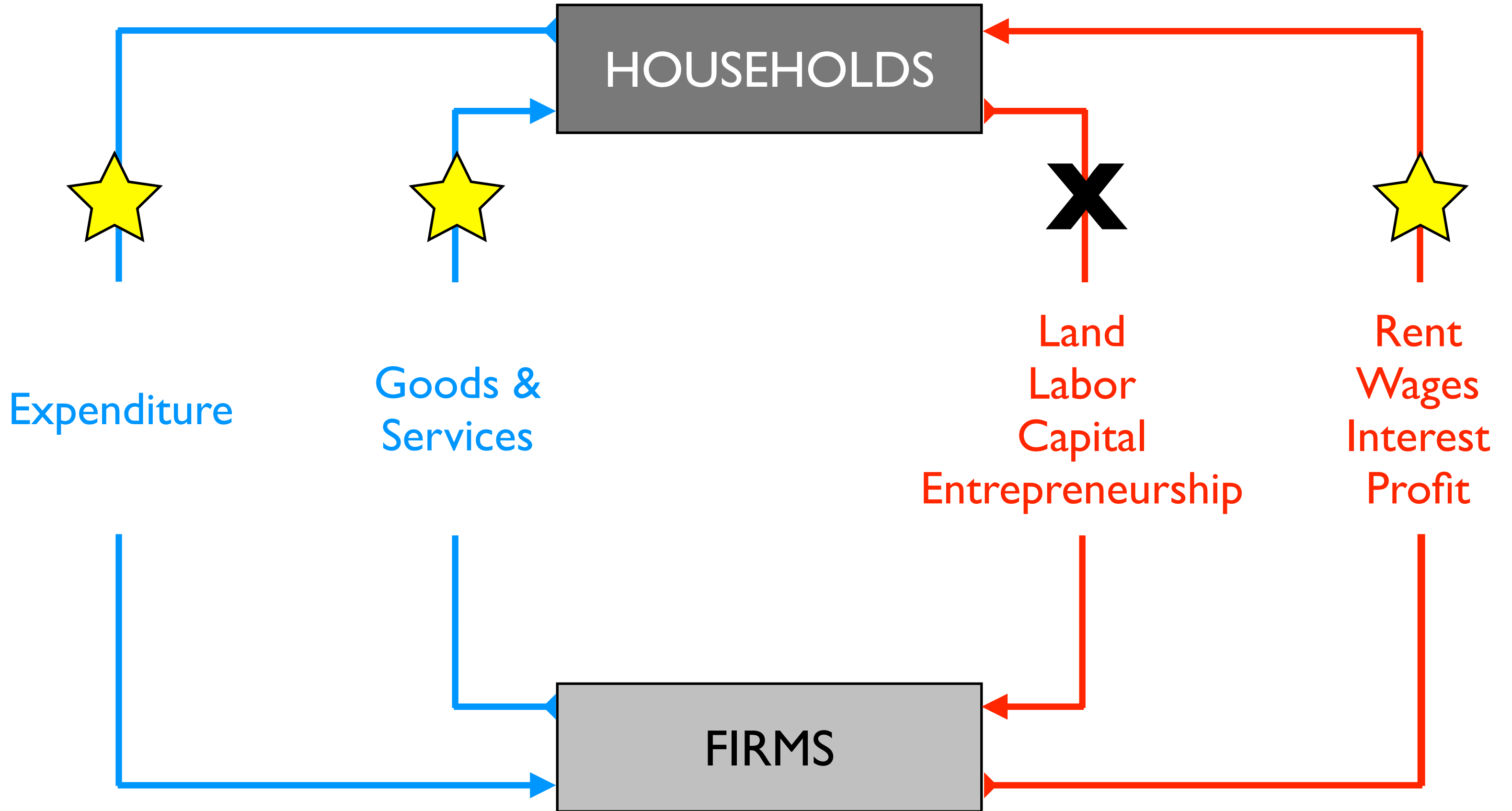
HOUSEHOLDS

It is too difficult to
measure the value of the
factors of production used,
so this path is not
attempted.

Land
Labor
Capital
Entrepreneurship

FIRMS





In order to be accurate, any increase in **GDP** caused by rising prices (inflation) is ignored. We call this **real GDP** – “real” means that we have adjusted for inflation.

GDP is used to help us determine **economic growth** – whether or not the economy produced more goods and services this year as compared to last year.

To see if an economy has experienced **economic development**, a different statistic is used. The most frequently used statistic for economic development is the **Human Development Index** (or **HDI**).

HDI takes **GDP** per person and adds in measures of the adult literacy rate, average years of schooling, and life expectancy in order to determine if the average person's welfare is better.

Economic growth is measure of *quantity*, while economic development is a measure of *quality*.